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Regional Integration and Development in Small States

Maurice Schiff

Small states should pursue unilateral and multilateral trade liberalization, and members of the African, Caribbean, and Pacific (ACP) group should expand reciprocal agreements with the European Union (Cotonou Agreement) to the entire OECD. They should also intensify South-South regional cooperation in the area of regional public goods.

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Summary findings

Schiff examines the impact of various trade policies for small developing states in the face of changing international trends—including globalization, the proliferation of regional integration agreements, the changing relationship between African, Caribbean, and Pacific (ACP) countries and the European Union, the erosion of ACP preferences in the EU market, the Everything-But-Arms Initiative (a 2001 EU initiative providing 49 developing countries free access to EU markets), and the negotiations on the Free Trade Agreement of the Americas. The author concludes that:

- The participants in South-South regional integration agreements should further reduce their external trade barriers.
- The trade component of the Cotonou Agreement between the ACP countries and the European Union is likely to harm those countries. The ACP countries should liberalize their trade regimes to reduce the size of transfers to the European Union.
- Small states should sign free trade agreements with the rest of the OECD and pursue multilateral liberalization.
- Small states and other developing countries should intensify South-South regional cooperation in the area of regional public goods.
- The EU and other OECD countries should provide country-specific technical assistance for "behind the border" reforms in small states—something specified in the Cotonou Agreement for ACP countries—as well as assistance in implementing their commitments under World Trade Organization agreements.

This paper—a product of Trade, Development Research Group—is part of a larger effort in the group to examine regional integration issues. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Paulina Flewitt, room MC3-333, telephone 202-473-2724, fax 202-522-1159, email address pflewitt@worldbank.org. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at mschiff@worldbank.org. February 2002. (28 pages)

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Maurice Schiff

Development Research Group

The World Bank

Address:
1818 H Street, N.W.
Washington, D.C. 20433
Tel: 202-338-8079
Fax: 202-522-1159
mschiff@worldbank.org

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*Correspondence: **mschiff@worldbank.org**. Thanks are due to Constantine Michalopoulos and L. Alan Winters for their comments.

Acronyms

ACP	African, Caribbean and Pacific countries
AFTA	Association of Southeast Asian Nations (ASEAN) FTA
AU	African Union
CAP	Common Agricultural Policy
CARIBCAN	Canada
CARICOM	Caribbean Community and Common Market
CBI	Cross-Border Initiative
CEMAC	Communaute Economique et Monétaire de l'Afrique Centrale (Economic and Monetary Community of Central Africa)
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
CU	Customs Union
EAC	Kenya, Tanzania, Uganda
EBA	Everything-But-Arms Initiative
EC	European Commission
ECOWAS	Economic Community of West African States
EPA	Economic Partnership Agreement
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FTAA	Free Trade Agreement of the Americas
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GSP	Generalized System of Preferences
IOC	Indian Ocean Commission
LDC	Least Developed Country
MERCOSUR	Mercado Comun del Sur (Southern Cone Common Market)
MFA	Multi-fiber Arrangement
MFN	Most Favored Nation
MSG	Melanesian Spearhead Group (Solomon Island, Papua New Guinea, Vanuatu, and Fiji (all World Bank members)
NAFTA	North American Free Trade Agreement
OAS	Organization of American States
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
OECS	Organization of Eastern Caribbean States
QUAD	Canada, EU, Japan, US
REPA	Regional Economic Partnership Agreement
RIA	Regional Integration Agreement
ROW	Rest of the World
SAARC	South-Asian Association for Regional Cooperation
SACU	Southern African Customs Union
SADC	Southern African Development Community

SELA	Sistema Económico Latinoamericano
SIDS	UN grouping of "Small Island Developing States"
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
SPS	Sanitary and Phyto-sanitary Standards
UEMOA	Union Economique et Monétaire Ouest-africaine (West African Economic and Monetary Union)
UNCLOS	UN Conference on the Laws of the Sea
UNCTAD	UN Conference on Trade and Development
US	United States
UTL	Unilateral Trade Liberalization
WTO	World Trade Organization

Regional Integration and Development in Small States

1. Introduction

Small states differ from other economies in a number of aspects, including their greater vulnerability to changes in the external environment.[1] This has been recognized by the WTO (World Trade Organization) (2001) which has agreed to examine issues relating to the trade of small economies.[2] Recent changes in the external environment include the change in the relationship between the EU (European Union) and the ACP (African, Carribean and Pacific) countries, the erosion of ACP preferences in EU markets, negotiation of the FTAA (Free Trade Area of the Americas), and the general proliferation of trade blocs. This paper addresses these issues, including what small states should do about them.

The policy options of small states are constrained by their endowments, their institutional development and their past policies. Small states are also constrained by bilateral, regional and/or multilateral commitments with respect to their trade policy. Some international constraints on policy may be beneficial (e.g., membership in the WTO is likely to improve policy credibility) while others are likely to be harmful.

Table 1 shows the list of 41 small states as defined by the World Bank (column 1). Most of them are also signatories to the ACP-EU Cotonou Agreement (column 2). Only 14 of them are least developed countries or LDCs (least developed countries) (column 3). Most are members (27) or observers (8) of the WTO (35 in total; column 5), 30 of them

[1] For a different view, see Srinivasan (1986). He argues that the economic and social problems some of the small states face are not necessarily due to smallness.
[2] The Draft Ministerial Declaration for the Fourth Session of the WTO's Ministerial Conference states (paragraph 30, page 7): "We agree to a work programme, under the auspices of the General Council, to examine issues relating to the trade of small economies ... The General Council shall review the work programme and make recommendations for action to the Fifth Session of the Ministerial Conference."

are members of the Commonwealth (column 6) and 28 are members of the SIDS (UN grouping of "Small Island Developing States"; column 4).[3] Column 7 shows that small states belong to a total of seventeen regional integration agreements (RIAs), most belong to at least one RIA, and several belong to from two to four RIAs. Note that this paper is only concerned with low-income small states and not with high-income ones (such as the Bahamas, Bahrain, Cyprus, Malta and Qatar).

With increased globalization, the expansion and deeper integration of large trade blocs, the changing relationship between the EU and ACP countries, the latter's erosion of preferences in EU markets, and FTAA negotiations, small states are facing important decisions about the types of policies to pursue in order to minimize the costs of adverse changes and take advantage of beneficial ones. The alternative policy choices include unilateral trade liberalization (UTL) and related domestic reforms, South-South integration among small states or between small states and other developing countries, improved South-South cooperation on regional public goods, North-South integration between small states and large Northern partners or blocs—including the FTAA and relations between ACP countries and the EU, and liberalizing multilaterally.

The remainder of the paper is organized as follows. Section 2 examines the impact of South-South RIAs among small states or between small states and other developing countries on the welfare of the RIA as well as on individual member countries, and Sub-section 2.1 provides implications. Section 3 analyzes South-South regional cooperation on public goods (Sub-section 3.1), for international negotiations (Sub-section 3.2), and the link between RIAs and regional cooperation (Sub-section 3.3). Section 4 examines

[3] Valdes and McCalla (1999) provide more detailed country classifications. They also show that some small states are very dependent on food imports, with the ratio of the value of *food* imports to *total* exports equal to 1.99 for Gambia, 1.68 for Grenada, 2.12 for Kiribati and 2.31 for Samoa.

RIAs between small states and Northern countries or blocs. Sub-section 4.1 describes existing agreements and the eroding preferences in the EU, Sub-section 4.2 analyzes the welfare implications, Sub-section 4.3 looks at technical assistance for "behind the border" reform, Sub-section 4.4 examines implications for credibility and FDI (foreign direct investment), and Sub-section 4.5 examines "hub and spoke" issues. Section 5 concludes with a set of policy recommendations.

Unlike standard trade theory, the theory of regional integration has been able to produce almost no unambiguous results. Thus, fully unambiguous policy recommendations are typically not feasible in this area. Nevertheless, results from recent theoretical, empirical and case study research enables us to provide reasonably robust case-specific policy advice. This paper provides such advice in the case of small states.

2. South-South RIAs

A number of small states have formed South-South RIAs (such as CARICOM (Carribean Community and Common Market) and the OECS (Organization of Eastern Caribbean States); see notes in Table 1 for definitions) or have joined other developing countries in South-South RIAs (AFTA (Association of Southeast Asian Nations (ASEAN) FTA); SAARC (South Asian Association for Regional Cooperation); CEMAC (Communaute Economique et Monétaire de l'Afrique centrale (Economic and Monetary Community of Central Africa)); SACU (Southern African Customs Union); SADC (Southern African Development Community); UEMOA (Union Economique et Monétaire Ouest-africaine (West African Economic and Monetary Union)); and more;

see Table 1). And in July 2001, CARICOM heads of government decided to finalize the CARICOM "Single Market and Economy" by early 2003.

As several studies have concluded, a South-South RIA that provides preferential access to its member states but keeps its external trade policy with respect to the ROW (rest of the world) unchanged is likely to lower welfare for the bloc as a whole (Panagariya, 1997; Schiff, 1997; World Bank, 2000). Some member countries may also gain at the expense of others and I return to this below.[4]

The reason South-South RIAs are likely to result in a welfare loss for the bloc as a whole is as follows. Assume first that imports are homogeneous, i.e., their characteristics do not depend on the country of origin. It is likely that members of South-South RIAs will continue to import from the excluded countries after the formation of the RIA (as found by Amjadi and Winters, 1999, for MERCOSUR (Mercado Comun del Sur (Southern Cone Common Market)). In that case, prices cannot fall since domestic prices continue to be equal to world prices plus the tariff on imports from the ROW. Since prices are unchanged following the formation of the RIA, output, consumption and imports are unchanged as well. Since total imports do not increase, there can be no trade creation. However, imports from other member countries increase after removal of intra-bloc trade barriers, at the expense of cheaper imports from excluded countries. This trade diversion lowers the welfare of the bloc as a whole.

Liberalizing trade with the ROW can turn harmful RIAs into beneficial ones if liberalization is deep enough. Thus, the best way to insure that South-South RIAs are

[4] An exception may be Botswana, a member of SACU. Since the external trade policy of SACU has been determined by South Africa, interest groups in Botswana have had no influence on it and resources have not been wasted on rent seeking activities by these groups in order to influence trade policy in their favor. This has been of great benefit to Botswana, which seems to have gained from membership in SACU, though it has been argued that SACU is more properly viewed as a North-South than a South-South RIA.

beneficial is for member countries to liberalize their trade regime with respect to the ROW.

If imported goods are heterogeneous, say because the quality of goods differs by country of origin, then the price of the member countries' imports is likely to fall under competition, with an ambiguous impact on welfare. However, if exports to the small member states by larger member countries are made under non-competitive conditions, then the exporting countries may appropriate all or most of the rent created by the removal of tariffs on intra-bloc trade and small states are likely to lose.

In fact, there are other reasons why the larger and more developed member countries are likely to benefit at the expense of the smaller and less developed ones. This asymmetric distribution of gains and losses is reflected in the fact that the larger and more developed economies of CARICOM (Barbados, Jamaica, Trinidad and Tobago) welcomed the decision to finalize a CARICOM "Single Market and Economy" by early 2003, while " ... smaller and economically weaker territories have strong doubts over whether they will benefit in the near and medium term, given the relative backwardness of their goods and tradable services sector." (Oxford Analytica, July 31, 2001).

Why do larger and more developed members typically gain from a RIA relative to smaller and poorer members? One reason is that the former usually have a trade surplus with the latter. The larger and more developed countries tend to produce protected manufactures which compete with imports from the ROW and which are exported to the smaller, poorer neighboring countries. Once the RIA is formed, these manufactures are sold to the poorer countries free of tariffs. This results in a transfer of tariff revenues from the poorer to the more developed countries (without benefit for the consumers in the poorer countries since prices do not fall due to the unchanged tariffs on imports from the ROW). This is equivalent to a worsening of (improvement in) the terms of trade for the poorer (more developed) member countries.

Consequently, not only is it likely that the trade bloc as a whole will lose from forming a RIA but the smaller and poorer member countries will lose even more, while the more developed members are more likely to gain. A second reason for the asymmetric gains and losses is related to agglomeration effects, whereby industry tends to leave the smaller and poorer members and agglomerate in the more developed ones once trade barriers between them are removed. A third reason is related to the fact that South-south RIAs tend to generate dynamic divergence, with the poorer members losing relative to the more developed ones (World Bank, 2000).

The asymmetric distribution of gains and losses from a RIA can result in tensions and even conflict between member countries (World Bank, 2000). This occurred in the 1960s when the East African Community broke down because of Tanzania and Uganda's dissatisfaction with what they perceived to be an unfair distribution of revenues in favor of (the more developed) Kenya. The same occurred in the Central American Common Market in the 1960s, when Honduras left the RIA after the more developed El Salvador refused to renegotiate the distribution of revenues. And poorer regions have tried to secede because of the unfavorable trade policy imposed on them by the dominant region. Such regions include the Southern part of the US in the 19th century and East Pakistan (later Bangladesh) in the 1970s.

One way to mitigate the problem associated with the asymmetric distribution of gains and losses is to have a compensatory mechanism put in place as part of the CU agreement. This is the case for the UEMOA, where compensation is based on intra-bloc trade flows prevailing before the agreement was signed. This does help mitigate the problem but does not fully resolve it because intra-bloc trade tends to increase following the formation of the CU (Customs Union), and the related increase in the level of transfers is not compensated for.

Another way to mitigate the problem is to lower the common external tariff (CET) because this reduces the size of intra-bloc transfers, whether positive or negative. Of course, the member country that obtains positive transfers from the CU may be unwilling to go along and lower the CET. That is where a FTA (Free Trade Area) has a clear advantage because it enables each member country to liberalize its trade policy with the ROW unilaterally and thus reduce the size of the transfers it may be providing its partners.[5]

2.1. Implications

An implication from the above is that small states that are members of South-South RIAs will benefit from lowering external trade barriers with respect to the ROW. They will benefit economically from the standard gains from trade, and they will gain politically (be politically more sustainable) because lower external barriers will mitigate the size of transfers from the less to the more developed member countries and will dampen any potential frictions between them.

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[5] Note that the scarcest resource for a small state is the administrative capacity needed to deal with the large number of bilateral, regional and multilateral issues it faces (see Section 3.2 below). RIAs are typically complex and require large amounts of administrative resources both for negotiation and for operating it. Given the low, if not negative, welfare impact of South-South RIAs, it is likely that such resources could be used more productively for the management of essential public programs.

The World Bank *Trade Blocs* Policy Research Report (2000) concludes that North-South RIAs are likely to be superior to South-South RIAs, though not necessarily to UTL. In this context, note that in July 2001, the Organisation of African Unity adopted a treaty defining a new organization, the African Union (AU), modeled directly on the EU (Oxford Analytica, July 18, 2001). The move toward increased integration in Africa—a region with ten small states--seems to be in the opposite direction of what experience and theory about regional integration would recommend. And the focus on this issue and the related use of scarce administrative and other resources is likely to distract from the important reforms needed to accelerate development in the region. Similarly, it is unclear whether the CARICOM "Single Market and Economy" initiative will provide the answer to the challenges member countries are likely to face in the near and medium term.

3. Regional Cooperation

3.1. Regional Public Goods

If countries deal with regional public goods individually, without internalizing the effect on other countries in the region, it may result in what has been called "the tragedy of the commons" or "prisoner's dilemma" where everyone loses due to a lack of cooperation. Thus, regional cooperation on public goods—such as water basins (lakes, rivers), infrastructure (roads, railways, dams), the environment, hydroelectric and other sources of energy, fisheries, and more-- can generate large benefits.

Regional cooperation has been supported by the World Bank across the developing world, together with other multilateral, regional and bilateral agencies. The World Bank provides expertise, financing and credibility. The latter is often crucial for the success of the project because joint projects imply binding commitments and thus some loss of sovereignty, and countries may not fully trust their neighbors to comply with their commitments. The World Bank can also help when power relations are asymmetric. For instance, the Caribbean countries successfully cooperated in resolving the problem of refuse produced by the cruise lines, and the World Bank provided important support to Caribbean countries in their negotiations with the cruise line companies.

3.2. International Negotiation

Other areas where small states can benefit from regional cooperation include visibility and international negotiations. For instance, CARICOM has attained a degree of visibility that no single member could have hoped to attain individually. As for negotiations, small states face severe disadvantages in their dealing with the ROW due to low bargaining power and high fixed costs of negotiation. Due to their small size, small states do not usually possess the needed human and physical capacities to unilaterally conduct all the bilateral and multilateral negotiations that are typical for developing nations. Forming a regional grouping with neighboring nations may help a country share its fixed negotiation costs and increase its bargaining power. Andriamananjara and Schiff (2001) have shown that the probability that small states will cooperate, as well as the equilibrium group size (number of cooperating members), the optimal group size, and the number of issues tackled, all increase with the degree of similarity between the member countries and with the level of international negotiation costs.

Small Caribbean nations, for example, have benefited from the establishment of CARICOM under which they have pooled their negotiation resources and have formulated common policy stances in negotiations on trade and investment with larger countries or regional trade blocs. Specifically, CARICOM countries have been involved, among other things, in the ACP-EU, GATT/WTO (General Agreement on Tariffs and Trade/WTO), UNCTAD (UN Conference on Trade and Development), UNCLOS (UN Conference on the Laws of the Sea) negotiations as well as in various commissions or joint councils with Canada, Cuba, Japan, Mexico, the US (United States), the FTAA, the OAS (Organization of American States), the G3 (Mexico, Venezuela, Colombia), the SELA (Sistema Económico Latinoamericano), and many more. Moreover, by trading each other's support, the CARICOM nations succeeded in getting their nationals elected to key international positions such as Commonwealth Secretary-General and ACP Secretary-General.

3.3. RIAs and Regional Cooperation

One question is whether a RIA is necessary or helpful for successful regional cooperation. The literature on this topic has not reached a consensus. Schiff and Winters (forthcoming) conclude that, though a RIA may be helpful under the right circumstances, it is by no means necessary. RIAs can help foster an atmosphere of trust and a history of negotiation that can help negotiations on regional public goods by embedding them in a wider framework. On the other hand, as discussed in the previous section, RIAs can result in tensions among member countries when the distribution of gains and losses is asymmetric, and this can make it harder to reach a cooperative solution on regional public goods.

4. North-South RIAs

4.1. Existing Agreements and Preference Erosion

Most small states are members of the ACP agreements with the EU and benefit from preferential access to it. Second, the EU's 2001 Everything-But-Arms Initiative (EBA) provides forty nine LDCs – not all small states – with free access to EU markets. And New Zealand and Norway have created their own EBA-type initiative (Hoekman, 2001). Moreover, Caribbean countries also benefit from preferential access to the US (under the Caribbean Basin Initiative) and to Canada (under CARIBCAN (Canada)). The US has also recently signed the Africa Bill. Finally, Caribbean countries and Belize are negotiating the FTAA with the other countries of the Western Hemisphere.

Small states are concerned with the expected erosion of preferences, especially in the EU markets. These preferences are eroding because

i) of the Uruguay Round, where the loss of preferences has been estimated at 1 percent for African and Pacific countries and at 3 percent for Caribbean ones (Overseas Development Institute study quoted in Bocquet, 1998);

ii) the EU has signed a CU with Turkey and FTAs with Mediterranean countries (Euro-Med Agreements), Central and Eastern European countries (Europe Agreements), South Africa and Mexico, and is negotiating with MERCOSUR and Chile, all of which will give these countries a tariff regime broadly equivalent to Lomé (EC DG-VIII, Section 3.2, 1999);

iii) the reform of the CAP (Common Agricultural Policy) will lower ACP preferences in beef and veal;

iv) the WTO ruling against the EU will eliminate preferences on bananas by 2006; and

v) the dismantling of the MFA (Multifiber Arrangement).

According to EC DG-VIII (1999), by the year 2000, Lomé preferences should only be 2.9 percent on the basis of the MFN (Most Favored Nation) trade regime and 2 percent on the basis of the GSP regime.

Moreover, ACP countries will only be able to maintain these eroding preferences in the EU markets if they provide reciprocity to the EU, i.e., if they give the EU preferential access to their own markets. Based on a number of factors, including whether the WTO would continue to provide waivers for Lomé-type agreements, the EU decided to replace the Lomé Convention with a new arrangement (EC, 1997). The future EU-ACP relations have been codified in the Cotonou Agreement, which was signed in June 2000. Its main principles in the area of trade are reciprocity and differentiation. The latter means that conditions for LDCs will differ from those for the other ACP countries (e.g., no reciprocity requirement).

Reciprocity means that the EU will form FTAs with groups of ACP countries. The latter would first form their own RIAs (e.g., UEMOA, CEMAC, EAC (Kenya, Tanzania, Uganda), SADC, CARICOM) and the EU in turn would form FTAs with them. The new agreement proposes that ACP countries enter into Economic Partnership Agreements (EPAs) with the EU, either as regional groups (regional EPAs or REPAs (Regional Economic Partnership Agreements))—the option favored by the EU—or individually.

Negotiations on EPAs are due to start after September 2002 and be implemented by 2008 when the Cotonou Agreement ends. Countries also have the choice of opting out of any EPA with the EU. In that case, they would lose preferential access to EU markets, unless they are members of the EBA.

The EBA provides forty nine LDCs access to the EU free of tariffs and quotas, with immediate implementation except for transition periods for bananas, rice and sugar where tariffs are to be phased out over the next eight years.[6] EBA members will be able to maintain preferential access to EU markets even if they do not enter into EPAs or REPAs with the EU. The EBA agreement is an inexpensive step for the EU, and provides support for the poorest nations concerned. However, as argued in Sub-section 4.2, it may hurt other developing countries.[7]

4.2. Welfare Implications

Under the Cotonou Agreement, ACP countries (except the poorest) must grant the EU preferential access. This is likely to hurt the ACP countries overall. From their viewpoint, what matters mainly are transfers of tariff revenues, which may occur in the absence of any efficiency effects of trade creation or trade diversion. Opening ACP markets to the EU is likely to result in transfers of tariff revenues from ACP countries to the EU, and this will worsen their terms of trade and result in a welfare loss. The reason is that since ACP imports from the ROW still have to pay the tariff, prices in ACP countries are unlikely to fall with the Cotonou Agreement. Thus, the EU will be able to

[6] Not all members of the EBA group are members of the ACP, though many are.
[7] Note that the trade component of the Cotonou Agreement is still subject to review by the WTO, and that it is not certain to be implementable in practice.

sell its exports to ACP countries at a higher price because they will enter duty-free, and it will be able to capture all or most of the tariff revenue that it was paying before.

If EU products are imperfect substitutes for non-EU ones and are competitively supplied, the price of EU exports to ACP countries may fall following the tariff cuts, and the worsening in ACP countries terms of trade will be dampened, with an ambiguous impact on ACP countries' welfare. However, if, as is likely, EU firms supplying small ACP countries have considerable market power, they will be able to capture much of the tariff cut themselves. This implies that the loss in ACP countries' terms of trade is unlikely to be dampened in those cases where EU and non-EU products are imperfect substitutes.

Countries can choose not to enter into (R)EPAs with the EU, in which case—and as long as they are not EBA countries--they are likely to lose some of the preferences they currently receive from the EU (they will still have access to the GSP). Thus, the potential loss of the benefits of preferential access to the EU for non-EBA countries must be taken into account. But, as discussed below, even with the loss of preferential access to the EU—whose value has been falling over time and has been estimated at 2% over the GSP (Generalized System of Preferences) (EC, 1999), the net impact of (R)EPAs is likely to be negative.

It has been argued that since ACP countries' trade shares with the EU are large, trade diversion is likely to be small. In fact, there is no direct link between trade shares and trade diversion (Schiff 1997; 2001). More importantly, large import shares imply large transfers from ACP countries to the EU. Only if the EU were the only supplier before ACP-EU FTAs were formed because the EU was the cheapest source (possibly due to lower transport costs),[8] or if its supply were highly elastic at the world price so that it became the only supplier after the FTA was formed, would the ACP countries gain on the import side from a RIA with the EU. However, empirical work suggests that situations where RIAs lead to such corner solutions are infrequent (Amjadi and Winters 1999) while Winters (forthcoming) argues that the bulk of ACP imports are likely to be supplied both by EU and non-EU suppliers.

Page (2000, p. 7) lists several studies showing the negative impact of REPAs between ACP countries and the EU. For Southern Africa, a study by Bussolo (1999) examines SADC's policy options. He concludes that unilateral trade liberalization (UTL) by all SADC members is superior to a FTA between SADC and the EU. SACU gains about the same under both scenarios, but the rest of SADC gains about three times more under UTL. Real wages also rise more under UTL. Note that these results obtain even though the study tends to favor regional integration by assuming competition and products differentiated by country of origin.

For Eastern Africa, McKay et al. (2000) estimate the impact of a REPA between the EAC (Kenya, Tanzania, Uganda) and the EU in a model where EAC imports are either supplied by EU or by non-EU exporters but not by both. This implies that the REPA results in a decline in consumer prices, biasing the results in favor of the REPA. Nevertheless, they find that the welfare effect of the REPA is negative for the EAC.

One way to minimize the losses from transfers to the EU is for ACP countries to lower their external trade barriers. A second solution would be to have ACP countries enter into RIAs with the rest of the OECD (Organisation for Economic Co-operation and Development) (and possibly other countries). Small states and all ACP countries would

[8] This would be equivalent to unilateral liberalization.

benefit from liberalizing trade with the entire OECD rather than just with the EU because domestic prices would be more likely to fall and their economies would be more likely to benefit from competitive pressures. And they would gain from expanding market access to additional markets. Moreover, expanding market access to the entire OECD would mitigate the hub-and-spoke problem that ACP countries might face from reciprocal market access with the EU. Such a solution may be politically feasible given the fact that the US has signed an Africa Bill providing some preferences in the US market, and that Caribbean countries benefit from preferential access in the US (Caribbean Basin Initiative) and in Canada (CARIBCAN) and are negotiating the FTAA.

Finally, small states could benefit from further integration in the multilateral trading system. This has the potential of providing the best solution because it would not discriminate against small states and other non-EBA developing countries that are not members of the ACP. And it would also help mitigate the hub-and-spoke problem ACP countries might face in a reciprocal agreement with the EU.

As for the EBA initiative, Hoekman, Ng and Olarreaga (2001) show that the benefits for LDCs are small if restricted to the EU but would be significant if expanded to the QUAD (Canada, the EU, Japan and the US). And they would of course be even larger if expanded to the entire OECD. Note that the EBA initiative for LDCs is likely to hurt non-LDC developing countries for two reasons. First, any expansion of LDC exports to the EU is likely to be mainly trade diversion away from exporters who are not quite poor enough to qualify for EBA preferences, because it is the latter who are currently exporting the goods that compete with those of EBA countries in EU markets. Second, Srinivasan (2001) argues that special and more favorable treatment to LDCs may give

OECD countries an excuse to delay the full opening of their markets to exports from developing countries in general.

4.3. Technical Assistance for "Behind the Border" Reform

Small states and other developing countries are likely to benefit from technical assistance from the EU (and other OECD countries) in the areas of legal and institutional reform. These areas include sanitary and phyto-sanitary (SPS) standards, technical standards, investment code, competition law, property rights, and contract law. Such "behind the border" reforms are likely to expand trade and raise economic growth by increasing efficiency as well as domestic and foreign investment, and benefits will be greater if the reforms are applied on a MFN basis. EU assistance in the area of "behind the border" reform is part of the Cotonou Agreement.

Finger and Schuler (2000) argue in the context of the Uruguay Round that "one size does not fit all." This principle also applies to the support for "behind the border" reforms provided in the context of a North-South RIA. Support for legal and institutional reform by the North based on some harmonization principle, whereby institutions of the South are brought up to par with those of the North, may not provide the expected benefits. A superior strategy would be to provide technical support that is adapted to the specific needs of the receiving countries. Thus, assistance by the North should focus on country-specific "behind the border" reform of institutions and policies in the South. The North should also provide assistance in the implementation of WTO commitments.

4.4. Credibility and FDI

It has been claimed in the literature that North-South integration, such as the Cotonou Agreement, will provide small states and other Southern partners with improved credibility with respect to their economic policies, and that this will attract increased flows of FDI. For instance, Whalley (1996) argues that NAFTA (North American Free Trade Agreement) had such an impact for Mexico. It is argued here that Mexico is a special case and that North-South RIAs can only enhance the credibility of the Southern's partner's policies if the partner already reformed its policies unilaterally.

First, Mexico had unilaterally reformed its economic policies before NAFTA was formed. Second, a developing country is only likely to gain credibility from a RIA with a large Northern partner if the latter is willing to impose sanctions whenever the Southern partner violates some aspect of the agreement (Schiff and Winters, 2001).

In other words, the Southern partner must be sufficiently important for the Northern partner to invest resources in the careful monitoring of the Southern partner's behavior with respect to all aspects of the agreement and in the process of imposing sanctions. This is clearly the case for Mexico which has a long border with the US, from (or through) which most immigrants and drugs enter the US, and whose political and social stability matters greatly to the US. This is less likely to hold for small states located far away from the EU, though it may be more likely to hold for Caribbean countries which are also a source of migration to the US.

On the issue of credibility and unilateral reforms, the difference after accession to the EU between Greece on the one hand, and Portugal on the other, is quite revealing. By acceding to the EU, these countries adopted the entire "acquis communautaire" and were thus much more closely integrated with the other EU countries than will be the case with small states in the Cotonou Agreement or in the FTAA. Nevertheless, Greece did not experience rapid increases in inflows of FDI and growth while Portugal did. The reason is that Portugal took advantage of the new opportunities provided by accession to the EU to implement macroeconomic policy reforms while Greece did not. On the contrary, transfers from the EU enabled Greece to postpone needed reforms.

Thus, North-South integration is not sufficient to enhance policy credibility and increase domestic and foreign investment, and it may not be necessary for most countries. A necessary condition seems to be the existence of liberal, transparent and sustainable domestic policies.

4.5. Hub and Spokes

The EU has signed FTA agreements with Mediterranean countries (Euro-Med Agreements), Central and Eastern European countries (Europe Agreements), South Africa and Mexico, and is negotiating with MERCOSUR and Chile. If, as proposed in the Cotonou Agreement, ACP countries were to sign (R)EPAs with the EU, they would become one of many spokes of the EU hub. And, other things equal, investors prefer to invest in the exporting sectors of the hub than in those of the spokes, because they can reach all the spokes from the hub but cannot do so from one of the spokes.

Consequently, ACP countries should try to become hubs themselves. The problem is likely to be less critical for small Caribbean states than for African and Pacific ones because of the Caribbean countries' preferential access to the US and Canada and the negotiations on the FTAA. However, at least for African and Pacific small states, the hub-and-spoke argument provides an additional reason why they should also try to enter into RIAs with the rest of the OECD, as well as pursue multilateral trade liberalization.

5. Conclusion

This paper examined the options for small states facing a changing external environment. The focus has been on the Cotonou Agreement which codifies the change to reciprocal relations with the EU, the erosion of preferences in EU markets, the EBA, and the FTAA.

The analysis presented leads to the following conclusions:

South-South RIAs among small states, or between them and other developing countries, are unlikely to raise welfare for the bloc as a whole and are likely to lower welfare for the smaller and less developed partner countries. Thus:

- South-South RIAs should lower external trade barriers, whether unilaterally (in a FTA) or by lowering the CET (in a customs union) as this will raise welfare and reduce tensions among partner countries;
- Small states and other developing countries should intensify South-South regional cooperation in the area of regional public goods;

Theory and empirical work has shown that (R)EPAs between ACP countries (small and other) and the EU in the frame of the Cotonou Agreement is likely to lower welfare for the former. Caribbean countries are likely to do better if the FTAA is formed. Consequently:

- ACP countries should liberalize their trade regime as it will make the Cotonou Agreement more attractive by reducing the size of transfers from the ACP countries to the EU;
- Small countries should sign FTAs with the rest of the OECD and should pursue multilateral liberalization; and
- The EU and other OECD countries should provide country-specific technical assistance for "behind the border" reforms in ACP countries—something specified in the Cotonou Agreement--as well as assistance in implementing their WTO commitments.

Table 1. Profile of Small States[1]

Country	World Bank (1)	ACP/ Cotonou (2)	LDC (3)	SIDS (4)	WTO (5)	Common-wealth Secretariat (6)	RIA (7)
Antigua and Barbuda	X[a/]	X		X	X	X	CARICOM[2], OECS[3]
Bahamas	X[a/]	X		X	O	X	CARICOM[2]
Bahrain	X[a/]			X	X		GCC[4]
Barbados	X	X		X	X	X	CARICOM[2]
Belize	X	X			X	X	CARICOM[2] OECS[3]
Bhutan	X[b/]		X		O		SAARC[5]
Botswana	X	X			X	X	SACU[6], SADC[7]
Brunei	X[a/]	X			X	X	AFTA[8]
Cape Verde	X[b/]	X	X	X	O		ECOWAS[9]
Comoros	X[b/]	X	X	X			CBI[10], IOC[11] COMESA[12]
Cook Islands		X[c/]				X[d/]	
Cyprus	X				X	X	EU candidate[13]
Djibouti	X[b/]	X	X		X		COMESA[12]
Dominica	X[b/**]	X		X	X	X	CARICOM[2] OECS[3]
Equatorial Guinea	X	X	X				CEMAC[14]
Estonia	X				X		Europe Agreement[15]
Fiji	X	X		X	X	X	MSG[16] SPARTECA[17]
Gabon	X	X			X		CEMAC[14]
Gambia, The	X[b/]	X	X		X	X	ECOWAS[9]
Gren ada	X[b/**]	X		X	X	X	CARICOM[2] OECS[3]
Guinea-Bissau	X[b/]	X	X		X		ECOWAS[9] UEMOA[18]
Guyana	X[b/]	X			X	X	
Kiribati	X[b/*]	X	X	X		X	SPARTECA[17]
Maldives	X[b/*]		X	X	X	X	SAARC[5]
Malta	X[a/]				X	X	
Marshall Islands	X	X[c/]		X			SPARTECA[17]
Mauritius	X	X		X	X	X	CBI[10], IOC[11] SADC[7] COMESA[12]
Micronesia, Federated States	X	X[c/]		X			SPARTECA[17]
Nauru		X[c/]		X		X	
Niue		X[c/]		X		X[d/]	
Palau	X	X[c/]		X			
Qatar	X[a/]				X		GCC[4]
Samoa	X[b/]	X	X	X	O	X	SPARTECA[17]
São Tomé and Principe	X[b/]	X		X	O		
Seychelles	X[a/]	X		X	O	X	CBI[10], IOC[11] SADC[7]
Solomon Islands	X[b/]	X	X	X	X	X	MSG[16] SPARTECA[17]
St. Kitts and Nevis	X	X		X	X	X	CARICOM[2] OECS[3]

Country	World Bank (1)	ACP/ Cotonou (2)	LDC (3)	SIDS (4)	WTO (5)	Common-wealth Secretariat (6)	RIA (7)
St. Lucia	X[b/**]	X		X	X	X	CARICOM[2] OECS[3]
St. Vincent and the Grenadines	X[b/**]	X		X	X	X	CARICOM[2]
Suriname	X	X			X		
Swaziland	X	X			X	X	SACU[6]
Tonga	X[b/*]	X		X	O	X	SPARTECA[17]
Trinidad and Tobago	X	X		X	X	X	CARICOM[2]
Tuvalu		X	X	X		X	
Vanuatu	X[b/*]	X	X	X	O	X	MSG[16] SPARTECA[17]
Total *45*	*41*	*38*	*14*	*28*	*35*	*30*	

Jamaica (SIDS, ComSec, IBRD, WTO), Lesotho (LDC, ComSec, IDA, WTO), and Namibia (ComSec, IBRD, WTO) invited as observers to Small States Forum though their populations are above 1.5 million.

[1] As defined in the Commonwealth Secretariat/World Bank Joint Task Force report, *Small States: Meeting Challenges in the Global Economy* (April 2000), "small states" includes countries with populations of 1.5 million or less.

X = Full membership; X[a/] Member of IBRD only, not member of IDA; X[b/] = IDA eligible borrower; X[b/*] = IDA eligible based on small islands exception; X[b/**] = eligible for blend funds based on small islands exception. X[c/] = Signatory to Cotonou Agreement only. X[d/] Member in association with New Zealand. **O** =Observer status.

[2] CARICOM = Caribbean Community;

[3] OECS = Organization of Eastern Caribbean States;

[4] GCC = Gulf Cooperation Council;

[5] SAARC = South Asian Association for Regional Cooperation;

[6] SACU = Southern African Customs Union;

[7] SADC = Southern African Development Community;

[8] AFTA = Association of Southeast Asian Nations (ASEAN) FTA;

[9] ECOWAS = Economic Community of West African States;

[10] CBI = Cross-Border Initiative;

[11] IOC = Indian Ocean Commission ;

[12] COMESA = Common Market for Eastern and Southern Africa ;

[13] EU candidate = candidate for accession to the EU ;

[14] CEMAC = Communaute Economique et Monétaire de l'Afrique centrale (Economic and Monetary Community of Central Africa);

[15] Europe Agreement = FTA between the EU and various Central and Eastern European countries;

[16] MSG = Melanesian Spearhead Group (Solomon Island, Papua New Guinea, Vanuatu, and Fiji (all World Bank members);

[17] SPARTECA = South Pacific Regional Trade and Economic Cooperation Agreement;

[18] UEMOA = Union Economique et Monétaire Ouest-africaine (West African Economic and Monetary Union);

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